

T-2244

DEVELOPMENT OF WESTERN RESOURCES

The Development of Western Resources is an interdisciplinary series focusing on the use and misuse of resources in the American West. Written for a broad readership of humanists, social scientists, and resource specialists, the books in this series emphasize both historical and contemporary perspectives as they explore the interplay between resource exploitation and economic, social, and political experiences.

John G. Clark, University of Kansas, General Editor

BREAKING THE IRON BONDS Indian Control of Energy Development

Marjane Ambler

1990



University Press of Kansas

CHAPTER FIVE

Who's Minding the Store? Indian Royalty Management

If I owned a butcher shop or a gas station and asked people to come in and take what they wanted and to pay their bills a month later, how long do you think I could stay in business?

—Chuck Thomas, USGS inspector¹

In the oil fields of the Wind River Indian Reservation on June 13, 1980, the sage- and sulfur-scented winds carried the rhythmic thumping sounds of the oil pumps and occasionally the yip of a coyote. The bobbing pumps lay far from the bustle of the reservation capital, Fort Washakie, and, until that day, far from the scrutiny of prying eyes. Then federal oil-field inspector Chuck Thomas, acting on a hunch, pulled an oil tanker over to the side of the road to check its credentials, shattering the calm of the high plains. Thomas, a Cherokee, worked for the U.S. Geological Survey (USGS), which was responsible for preventing thefts of federal and Indian oil. He figured the pipelines could carry nearly all of the oil produced on the reservation, meaning few if any trucks should be hauling oil from wells there. Just as he suspected, the driver did not have a "run ticket," the document authorizing him to remove oil from a federal or Indian well.²

Thomas sparked a full-scale investigation that spread quickly from the oil fields of Wind River to encompass the whole federal inspection and accounting system for Indian and federal lands. He also shifted the attention of Indian tribes across the West, which, with a few exceptions, had been focused primarily upon getting better terms in new mineral contracts. The tribes and individual Indian mineral owners (allottees) came to realize that they were not getting even the relatively small shares of revenue promised by their oil and gas contracts. Thomas's employer, the USGS, had not been doing its job. Inspectors had not assured that the oil fields were secured against thefts. The agency also had neglected to reconcile royalty accounts to be sure the companies were paying properly. Instead it had relied upon a seriously flawed honor system, and that system had failed.³

To states and tribes, oil and gas revenues were of vital importance. The states received 50 percent of the royalties from federal leases within their boundaries, except for Alaska, which received 90 percent. The Indians received all of the royalties from Indian leases. In the peak year 1982 the Indians earned \$198 million in royalties from oil and gas production. With the

drastic drop in federal grants and contracts under the administration of President Ronald Reagan, tribes began looking in the 1980s for ways to streamline their operations, limit their services, and make more efficient use of limited funds. Tribes with energy income became even more dependent upon that income, which also was dropping; by the spring of 1986 energy tribes had suffered a 30 to 60 percent decline in oil and gas income. Making sure that they were actually receiving the revenue to which they were entitled became ever more important.⁴

The energy tribes, like the states, needed the full value of this royalty income to help provide basic government services such as police and fire protection, natural resources management, road maintenance, health care, and education. On the Jicarilla Apache Reservation, for example, the tribe received about \$25 million in oil and gas revenue in 1986, with which the tribe paid for police and fire protection, schools, water and sanitation, and other social programs. Oil and gas royalties and taxes provided 85 percent of the tribe's total income. The Blackfeet Tribe derived 90 percent of its total income in 1985 from oil and gas royalties and taxes.⁵

To protect their ownership interests the tribes turned to their governmental powers. The sudden realization of the federal government's failings in royalty accounting forced the tribes to act. Often building new governmental institutions from the ground up, the tribes approached royalty management on two fronts. They hired energy police to provide site security in the oil fields, and they hired accountants to check the books for paper losses. As part of their accounting investigation they discovered serious inadequacies in the way that the government determined the value of the resources and in the government's lack of enforcement of diligence. In each of these efforts they relied upon political pressure and media exposure to force the government to recognize the differences in its responsibilities for the Indians' and for the public's minerals. The public royalty management controversy forced many painful reforms upon the Interior Department, including providing a bigger role for tribal governments. Yet the original problem—the lack of field security—was nearly forgotten.

SITE SECURITY INVESTIGATION

Although Chuck Thomas pulled the tanker over in June 1980, the story did not leak out until more than four months later when the *Rocky Mountain Journal* reported on the grand jury investigation. When his superiors would not act on his suspicions, Thomas had blown the whistle, taking his briefcase full of incriminating photographs to the Federal Bureau of Investigation (FBI). The following spring, as part of an investigation for the Senate Select Committee on Indian Affairs, Montana Senator John Melcher grilled USGS officials about their cover-up of Thomas's discovery. Although the

owes, the head of the commission investigating oil thefts, said Amoco security was "very weak." Department officials indicated they would be tough on offenders such as Amoco.²⁷

Interior, however, sabotaged its own attempt to improve its tarnished image. Just as in the Thomas run-ticket incident, it turned out that the department lacked a formal process for dealing with allegations of oil-field problems. Before giving Amoco a chance for rebuttal, Deputy Assistant Secretary Roy H. Sampsel told the Linowes Commission and the press that the department would be granting the tribes' request to cancel the leases. In fact, Amoco said it first learned of the tribes' petition by reading about it in the *New York Times*. Although Sampsel later that spring signed a statement swearing he was impartial and removing himself from the decision-making process, it was too late. Amoco attorneys quickly charged "foul" and filed a lawsuit, saying they had no faith in the impartiality of Interior officials who were to rule on the tribes' petition. They questioned the department's authority to cancel leases at all.²⁸

As Sampsel admitted to the Linowes Commission, "some form of due process needs to be spelled out." The cancellation petition was set aside as the court action dragged on for more than three years and as the company and the tribes tried to settle the dispute. Then, after Ross Swimmer (Cherokee) became assistant Interior secretary for Indian affairs in December 1985, he dropped the cancellation petition a month later, making the lawsuit moot. The tribes were outraged and won the support of the National Congress of American Indians in protesting Swimmer's action, which they felt sent a message to industry that Interior once again would tolerate even flagrant abuses of Indian lease terms. The Wind River tribes argued that Amoco would never have fought the cancellation so hard if it did not consider the case an important precedent. The Arapahoe Tribe's attorney said that Swimmer's office had not even consulted with them before canceling the petition, he believed Interior did not want to embarrass itself by trying to defend Sampsel's actions. Swimmer, who said he assumed the tribes had been consulted, argued that the litigation could have dragged on for ten years or more before the department would be allowed to even rule on the cancellation petition itself.²⁹ In the end Amoco settled with both the allottees and the tribes. Although on paper thousands of barrels of oil were unaccounted for, the tribes never had an opportunity to prove it in court. Ironically, through the settlement process the tribes and Amoco gained respect for one another and improved their working relationship.³⁰

INVESTIGATION RESULTS

The idea of thieves filching truckloads of oil, especially from Indians, captured national headlines for several months in 1980 and 1981. When the



Oil cannot be stolen without detection when a numbered seal such as this is used properly (Photo by Sara Hunter-Wiles)

dust settled and the initial federal investigations ended in 1982, most of the provable losses turned out to be the work of a sharp pencil, not a pipe wrench. No leases had been canceled and only a few people convicted. The Linowes Commission's investigation confirmed that USGS needed more inspectors, but it also found the field inspectors needed better training and supervisors with more backbone when diligent inspectors, such as Thomas, reported violations.³¹

Investigators traced the federal safeguards that had been designed to prevent oil from being stolen but that had not been enforced. Then and now, oil is generally measured not at the wellhead but at the point of sale. It is pumped from several wells into a battery of treatment facilities and storage tanks where it is held until sold. Most large-production leases use a lease automatic custody transfer (LACT) meter, which automatically measures the sale. On smaller-production leases, measurements are done manually by gauging the depth of the oil in the tank before and after a sale, with adjustments for temperature, gravity, and impurities. LACT meters are nearly tamper-proof. Automatic, sequentially numbered printouts from these meters record sales volume—but only if the piping passes through the meter. Since 1978 the federal government has required numbered seals, similar to boxcar seals used by trucking firms and railroads, which have to be broken before valves can be opened. Thus it is clear when a valve has been used—but only if it has been sealed. Federal regulations prohibit good oil from be-

ing stored in spill ponds because it can be taken without passing through meters.³²

Oil-field service companies—such as fresh-water haulers, hot oilers, reclaimers, and junk-oil dealers—had taken advantage of the loose controls. Junk-oil dealers, who supposedly haul waste oil out, actually in some cases pumped good oil into the junk-oil pits. By checking refiners' purchase records, the investigators found unauthorized individuals and companies had mysteriously acquired and sold large quantities of crude oil. Thefts ranged from fifty barrels to over a thousand. To avoid paying high royalties, companies sometimes transferred oil from a lease with a high royalty to one with a lower royalty. Purchasers sometimes exaggerated the amount of impurities (sediment and water) in a truckload of oil, lowering the value of the oil and thus the royalties. Dishonest operators sometimes would not report completion of a well and thus skip paying royalties on the first days of production, when flow rates are often the highest.³³

From all indications solid energy minerals, such as uranium and coal, did not present ready opportunities for theft because of their bulk (coal was worth less than \$30 a ton) and the relative security of coal and uranium production facilities. Investigators did not study the solid minerals as much because the total oil and gas royalties were so much higher. In 1980 Indian and federal coal royalties totaled only \$40 million and uranium only \$9 million, whereas oil and gas produced royalties of \$2.6 billion. The Linowes Commission said, on the other hand, that paper theft of coal and uranium royalties was likely. The commission's preliminary review of solid minerals found that general problems of verifying production, determining fair market value, and designing effective audit programs were common for all minerals.³⁴

At first it looked as if the site security investigations would result in many convictions. When USGS suddenly stepped up its inspection effort in 1980, the agency issued over two thousand citations to companies for site security violations that could have resulted in theft or mishandling of oil. The Linowes Commission heard testimony about interstate theft rings, kickbacks, and bribery. Private oil-field security investigators estimated to the *Denver Post* that 2 to 6 percent of all crude oil produced in the United States was being stolen at that time (1980–1981).³⁵

When it came down to proving that oil had been physically stolen and how much, however, investigators had a more difficult task for several reasons: poor records, an undeveloped process for penalizing violators, and investigators' emphasis on paper audits over site security. Chuck Thomas described the USGS system as an unminded store, but in fact the situation was worse. Because well production was not checked regularly by USGS, the storeowner had no baseline inventory to know what was missing. Neither the Indians nor the public would ever know how many thousands of dollars they lost to thieves in the oil fields. Only four men were convicted in Wyoming—

the president of an oil reclaiming company, a contract pumper, a pumper operator, and a trucker. A handful of oil thieves were also convicted in Oklahoma, New Mexico, and California. The oil companies themselves—including Amoco—emerged unscathed, even though the Linowes Commission and most other experts considered the companies responsible for not securing the oil fields against theft.³⁶

It would be impossible to assess how many more convictions there might have been if in 1981 the Interior Department had not shifted its focus in the middle of the investigation from physical thefts to paper audits. Linowes objected to the decision. Many experts—including Linowes and former USGS district engineer in Wyoming George Kinsel—felt convinced there were many physical thefts that did not leave a "paper trail." Nevertheless, James M. Yohe, assistant inspector general for investigations, decided to concentrate on audits instead. "Undercover investigating is not the only technique. It has a lot of romance and pizzazz, but I don't know if it's necessary," he said. Unfortunately, after the investigation's focus switched to auditing and accounting, federal agencies—and some tribes—forgot the importance of improving field security and inspections, which continued to be neglected for years.³⁷

The paper investigations clearly offered bigger, quicker payoffs for the royalty owners, who recovered millions of dollars. For example, soon after the Wind River tribes hired accountants to check their royalty records, Conoco, Amoco, and Gulf paid the tribes more than \$1.3 million in additional royalties. As with the field thefts, however, the Linowes Commission concluded that the total underpayments would never be known, much less recovered. The commission said Interior officials estimated one hundred million to several hundred million dollars a year could have been lost.³⁸

The investigations proved that the Interior Department had been derelict in fulfilling its responsibilities in the office as well as in the fields. USGS had been keeping records of, not accounting for, royalty payments. The records were often inaccurate because the system relied upon manual instead of computerized entries of information. Many USGS and BIA employees, who had been handling millions of dollars in mineral accounts for years, did not understand basic accounting practices. The federal royalty program was basically an honor system given that USGS did not verify data, did not know which companies had paid, rarely conducted audits, and did not impose penalties for nonpayment or underpayments.³⁹

The Osage Tribe and local BIA had discovered years earlier that penalties combined with effective monitoring succeed. A federal auditor found that only 0.3 percent of the payments to the Osages were late, compared with 70 percent for the Uintah and Ouray Reservation in Utah and 46.7 percent for the Jicarilla Apache Reservation in New Mexico. The Osage Tribe had computerized information for its 3,900 leases and required a late charge of 1.5 percent for each month the payment was late. The Linowes Commis-

sion found USGS almost never imposed penalties even for "gross, repeated underpayment of royalties," which prompted the commission to say, "It is remarkable that USGS royalty collection functions at all, considering that there are virtually no teeth to the system."⁴⁰ The Linowes Commission recommended throwing out the honor system but not because the members believed petroleum companies were without honor. "Underpayment often results from a defensible interpretation of a complex set of rules. Oil and gas companies may take the same approach that most people do with their taxes. Where there is a doubt, they interpret the rules to their own advantage, guarding against overpayment."⁴¹

The Linowes Commission had some kind words for USGS, calling it an "esteemed scientific organization" dedicated to the pursuit of the earth sciences. USGS accomplished well its primary mission to explore and map the geologic resources of the country. Unfortunately, federal and Indian leases were lowest on the agency's priority list. Thus the commission recommended creating a royalty management agency, separate from USGS just as the Bureau of Reclamation and Bureau of Mines had been separated from USGS in the past.⁴²

The Linowes Commission emphasized the importance of valuation and fieldwork, but the Interior Department gave both a lower priority in later years. The commission said the federal government should not just rely upon company-generated data. It should inspect each well each year and also periodically obtain well test data, run tickets, and LACT meter readings on a sample basis. To verify production the federal government would have to hire more inspectors so that it would be able to trace petroleum from the point of production to the point of sale, making sure that oil did not get "lost" before the royalties were paid. Most underpayments of natural gas royalties resulted from undervaluation, according to the commission. Because royalties were computed as percentages of the value of minerals sold, valuation was critical.⁴³

FEDERAL ROYALTY REFORMATION

In time the Interior Department adopted most of the Linowes Commission's recommendations. A dinosaur was dragged kicking and screaming into the twentieth century despite its deeply ingrained distrust of adaptation. The changes were painful not just for the institution but also for the Indian royalty recipients as the bureaucrats tried to figure out where the tribes fit into the new system. The reforms made important changes in the ways that the federal government accounted for mineral proceeds and provided for state and tribal participation. The reformation suffered from four serious flaws, however: moving too fast without planning, treating Indian tribal governments in the same manner as states, neglecting fieldwork, and giving too

much weight to industry comments and to efficiency when adopting valuation guidelines.

From the moment that Chuck Thomas blew the whistle, USGS and BIA had been under siege, resulting in an attempt to completely overhaul the royalty system in the space of a few years. With a flurry of activity, Interior showed its determination to do something—anything—quickly. Interior Secretary James Watt created a new Minerals Management Service (MMS) at Interior the same day (January 21, 1982) that the Linowes Commission issued its 267-page report. By the end of the year Congress had passed the Federal Oil and Gas Royalty Management Act (FOGRMA) to implement other Linowes Commission recommendations. Responsibility for field inspections had been shifted to the Bureau of Land Management (BLM), another agency of Interior.⁴⁴

Unfortunately, Interior was not quite sure where it was going before it took off. The department purchased a new computer to handle royalty accounting before MMS had been created or the management team hired to participate in the decision. The system could not handle the massive load of information, and a new one was delayed for years. In an internal memo in 1984 a top MMS official, Robert E. Boldt, called the computer system a "disaster—a very rudimentary system, developed quickly by an inexperienced contractor." Nevertheless, Boldt said MMS tried to keep up a good front between September 1981 and February 1983 by asking companies to pay the Lakewood Accounting Center, "*as if the new system were in place*" (emphasis added). As a result, some royalty owners did not receive any money for several months. Later Boldt said MMS realized its second big mistake—the computer hardware that it had purchased could not handle the volume of information. Boldt said in 1984 the error-ridden files still had not been completely unraveled or reconciled.⁴⁵

Moreover, because USGS had been completely understaffed, hundreds of new people had to be hired and trained. The agency had to start with USGS's totally inadequate data base; the old records were so far off when MMS started trying to reconcile them that MMS wrote off any balance under \$100,000. Fortunately, that policy was not applied to Indian leases. For the first several years, MMS was preoccupied with training people and cleaning up data, where possible. In addition, the transfer of inspection responsibilities to BLM did not go smoothly.⁴⁶ For example, rather than admitting its problems, MMS officials turned defensive during the transitional period. Congressional investigators found that the MMS management chose not to work cooperatively with the states and Indian tribes but rather chose to "circle the wagons," repeatedly saying that "all was well within the program without stepping back to analyze whether the program was being led in the right direction."⁴⁷

The Indians' transitional problems were aggravated by the fact that the new royalty management plan required three of Interior's "sister" agencies—MMS, BLM, and BIA—to work with each other. As one un-

named BIA employee said, "We couldn't get the three agencies to sing from the same song sheet." As the Indians launched verbal attacks against the circled wagons, each agency pointed fingers at the other to assign blame. Of the three agencies, only BIA was familiar with the federal government's special responsibilities to Indians. Possibly as a result of this ignorance, MMS initially audited only offshore federal oil leases, not Indian leases, because more dollars were at stake. Requests for audits of Indian leases became lost in the bureaucratic maze while Indian mineral owners lost their homes and cars as a result of unpaid royalties. These problems began to be resolved only after Congressman Mike Synar of Oklahoma publicly chastised MMS. He pointed out that Indians obviously suffered more than the federal treasury when royalties were not paid on time.⁴⁸

The FOGRMA set the stage for better royalty management by providing for civil penalties of \$500 to \$25,000 a day and criminal penalties of jail and \$50,000 for serious infractions; clarifying inspectors' authority; requiring regular audits and inspections; imposing additional site security and record-keeping responsibilities upon industry; and providing roles for states and Indian tribes.⁴⁹

By mid-1989 neither MMS nor BLM was fulfilling all the requirements of FOGRMA, and another investigation revealed that many of the same problems of field thefts and accounting errors persisted. Nevertheless, each agency had made some improvements as a result of reforms. Interior collected millions of dollars in civil penalties for violations. Just by training companies how to fill out forms the department reduced the error rate from over 40 percent in January 1983 to 4 percent in 1987. After six years of auditing, the federal government had collected \$12 million in additional royalties and \$3 million in late payment charges for Indian leases—an average of \$2.5 million a year that the Indians likely would never have received if Thomas had not pulled over the tanker in Wyoming.⁵⁰

By the end of 1987 the department had more than doubled its inspection staff, but it still did not have enough inspectors to check more than 92 percent of the high priority leases, not 100 percent, as required by FOGRMA. Moreover, the department had delayed final valuation regulations because of controversy over proposed changes. Thus two of the most important reasons for royalty problems—inspections and valuation—had not been resolved by 1988. Although far from perfect, the improvements that did occur—collection of civil penalties, error rate reduction, collection of millions of dollars in royalties and late payment charges, more regular audits and inspections, and involvement by states and tribes—inspired praise from William Proxmire, the senator from Wisconsin, who said, "Instead of a lashing, they deserve a pat on the back for beginning to do a difficult job well." The Interior Department's inspector general also said in April 1988 that the department had made considerable progress.⁵¹

FITTING INDIANS INTO THE SYSTEM

Although MMS and BLM had serious problems fitting Indians into the federal system during the transition, the Indians started with an advantage. FOGRMA was one of the first laws that provided for tribes' having the same authority as states. In the past the federal government frequently had ignored energy tribes when planning federal policy, which had brought criticism from CERT and others. The Linowes Commission and the Congress heeded such criticism and the Indians' insistence at royalty investigations that they would not be ignored after the Wind River exposé. As a result the debates centered upon "how" rather than "if" Indian governments would play a role in deciding upon and implementing royalty management policies.

To involve tribes and states Interior adopted Linowes Commission recommendations to appoint an advisory committee and to provide access to lease and royalty information. The royalty management advisory committee included members from industry, states, tribes, allottees, and the general public, who advised the department as it implemented its royalty management plan. Interior appointed representatives of seven tribes and an allottee association. Although MMS did not always abide by the committee's recommendations, the often heated discussions forced agency personnel to face the actual impacts of their policy decisions.⁵²

The State and Tribal Support System (STATSS) program gave states, tribes, and federal officials computer access to MMS financial data on leases with which they were concerned. MMS offered to train tribal royalty auditors at its offices in Lakewood, Colorado, through the Intergovernmental Personnel Act (IPA), and the two tribes that took advantage of the offer—the Navajo and the Northern Ute—gained tremendously from the training. Interior Secretary Watt invited states and Indian tribes to enter into cooperative agreements to increase oil-site inspection work and auditing.⁵³

These initiatives, which treated tribes as states, signified critical progress for tribal governments given that they had previously been ignored by Congress and federal regulatory agencies. It sometimes was difficult for tribes to take advantage of these opportunities, however, because the tribes were not just like states. Congress and MMS, which had some understanding of state governments and their capabilities, designed programs with them in mind, ignoring the special constraints faced by tribes, such as the lack of a tax base and of developed infrastructures.

When Senator Melcher chided some tribes in 1981 for not taking more responsibility for site security and royalty accounting, many energy tribes, including the Shoshone, Northern Ute, Navajo, and Jicarilla Apache, testified that they would be glad to—if they had the funding, the cooperation, and the authority they needed. The tribes recognized as well as Melcher the